Office of Chief Counsel
Internal Revenue Service

memorandum

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WGBissell

date: October 23, 2001

to: Carlton E. Anderson
LMSB Exam Group 1306
Stop 4330AUNW
South Texas Office

from: Area Counsel
(Natural Resources: Houston)

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subject: **TL-N-3571-01**
[redacted]
Capitalization versus Current Expense

QUESTION PRESENTED

The question presented is whether under the limited facts so far developed in this case the Service wants to strictly enforce the requirement that the taxpayer must capitalize the cost of acquiring long-term service contracts as explained in PLR 199952069. The facts are limited because the taxpayer has complained that full development of the facts will be expensive and time-consuming. The agent has agreed to seek counsel advice before requiring further factual development from the taxpayer.

FACTUAL SUMMARY

[redacted], with headquarters in [redacted] Texas was founded in [redacted] as a service contract company. It provides both government services and commercial services in the facilities and fleet management sectors of service contracting. Under the typical contract, [redacted] provides vehicle fleet services, such as maintenance, repair and fuel for most of a customer's vehicles and equipment.

During the [redacted] tax year, the taxpayer began contract negotiations with [redacted] potential clients and secured [redacted] contracts that were from [redacted] to [redacted] years in length. The taxpayer incurred costs for wages, travel, and consulting in obtaining the contracts.

(b)(4) [redacted]

(b)(4) [redacted]

(b)(4) [redacted]

(b)(4) [redacted]

$ [redacted]

LEGAL DISCUSSION

I.R.C. § 162(a) allows a deduction for ordinary and necessary expenses incurred in carrying on a trade or business. To qualify for the deduction, there must be an expense that is both ordinary and necessary, it must be paid or incurred during the taxable year, and it must be for carrying on a trade or business. *Commissioner v. Lincoln Savings and Loan Assoc.*, 403 U.S 345, 352 (1971). The term "ordinary" has been used to distinguish between those expenses that are currently deductible and those that are capital in nature and which must be deducted, if at all, by amortization over the life of the asset. *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966).

Under I.R.C. § 263, there is no deduction for the cost of permanent improvements or betterments made to increase the value of any property. Under *Treas. Reg.* § 1.263(a)-(2(a), costs must be capitalized if incurred to acquire property having a useful life substantially beyond the close of the taxable year. An expenditure is capital if it creates or enhances a separate and distinct asset or if it produces a significant long-term benefit. *Indopco v. Commissioner*, 503 U.S. 79 (1992) and *Commissioner v.*

Lincoln Savings and Loan Assoc., 403 U.S 345 (1971). The realization of benefits beyond the current year is an important but not conclusive factor in determining whether a cost must be capitalized. *Indopco* at 87-88.

A more recent case with facts closer to ours is *Lychuk v. Commissioner*, 116 T.C. No. 27 (filed May 31, 2001). *Lychuk* contains a discussion of virtually all the major cases that have decided the capitalization versus expense issue. In *Lychuk*, the income and deductions were passed through Automotive Credit Corporation (ACC), an S Corporation, to the taxpayers. The precise issue before the Court was whether the taxpayers had to capitalize certain expenditures made in 1993 and 1994. Those expenses were salaries, benefits and overhead (including printing, telephone, computers, rent and utilities) relating to ACC's acquisition of retail installment contracts in the ordinary course of its business.

ACC was incorporated in 1992 to provide alternative financing for purchasers of used automobiles who had marginal credit. Its sole business operation was the acquisition of installment contracts from car dealers who had sold cars to high credit risk individuals, and the servicing of those contracts. Its primary business activities were credit investigation, evaluation and documentation, and the monitoring and collection of payments on the installment contracts. The length of repayment on the installment contracts ranged from twelve to thirty-six months.

The Tax Court held that ACC had to capitalize the salaries and benefits because they were directly related to the acquisition of the installment contracts. They could expense the overhead, however, because those costs were only indirectly related to acquisition of the contracts. The Court based this conclusion on its holding that an expenditure must be capitalized when it creates or enhances a distinct asset, produces a significant future benefit, or is incurred in connection with the acquisition of a capital asset. In *Lychuk*, the expenditures were made in connection with the acquisition of a capital asset. They also produced a significant future benefit. The expenditures were made "in the process of acquisition itself," and were thus directly related to the acquisition of the installment contracts.

"In the process of acquisition" meant each employee of ACC spent a significant portion of work time on credit analysis activities, which was an indispensable part of the installment acquisition process. ACC would not have paid the salaries and benefits were it not for those activities. Since the credit analysis activities were so inextricably tied to the installment

acquisition process, the cost of those activities (salaries and benefits) had to be considered as part of the cost of the installment contracts. Overhead items, such as rent and utilities, would have been incurred anyway, even without the contract acquisition process, apparently because ACC would have continued to incur most of those expenses in the ordinary course of its business had its business only been to service the installment contracts. Future benefit from overhead expenses was thought to be incidental. Overhead expenses were thus currently deductible.

Other cases support this conclusion. *See* for instance *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974) (wages paid and the cost of tools and materials used in connection with the construction of power equipment must be capitalized); *X-Pando Corp. v. Commissioner*, 7 T.C. 48, 51-53 (1946) (salary, rent advertising and traveling expenses which would ordinarily be deductible are capital expenditures if made to develop a business, the benefits of which will be realized in future years); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982) (office supplies, filing fees, travel expenses and accounting fees incurred in connection with the acquisition of a capital asset must be capitalized); *Lykes Energy Inc. v. Commissioner*, T.C. Memo. 1999-77 (promotional and selling activities had to be capitalized since they were directly related to obtaining new customers); *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998) (expenses incurred in the creation of mutual fund management contracts provided the taxpayer with significant long-term benefits and had to be capitalized); and *Helvering v. Winmill*, 305 U.S. 79,84 (1938) (cost of buying securities capitalized as part of the cost of the securities and required to be capitalized, even though the taxpayer incurred such expenses regularly in his business of buying and selling securities). These decisions agree with Rev. Rul. 68-561, C.B. 1968-2, 117 and Rev. Rul. 71-469, C.B. 1971-2, 120, in which cash allowances to builders, homeowners and contractors to convert heating systems to gas were capital in nature. Fifth Circuit cases dealing with this subject agree with Supreme Court pronouncements on the issue generally, but add nothing to them. *See Cagle v. Commissioner of Internal Revenue*, 539 F.2d 409, 416 (5th Cir 1976) (expenditures made for the development of and office-showroom project required to be capitalized); and *Central Texas Savings & Loan Association*, 731 F.2d 1181, 1184 (5th Cir. 1984) (expenditures incurred in the acquisition of a capital asset generally must be capitalized).

The Tax Court in *Lychuk* observed that many of the cases deciding this issue are difficult to harmonize, and indeed this is the case. There are cases that go the other way with facts

that are difficult to distinguish. In *Metrocorp, Inc. v. Commissioner*, 116 T.C. No. 18 (April 13, 2001), a bank which partially assumed the assets and deposit liabilities of a failed savings and loan was allowed to currently expense the exit fee from one FDIC insurance fund and the entrance fee to another one. The Service had argued that the fees produced significant future benefits to the bank because they insured all of its deposit liabilities. The Court thought it was important that the bank would not have recovered any portion of either fee if it severed its relationship with the fund. This meant the benefit was current. The entrance fee was for the current year's insurance; the exit fee was a final payment for past insurance.

In *Sun Microsystems, Inc. & Consolidated Subsidiaries v. Commissioner*, T.C. Memo. 1993-467, stock warrants included in various agreements the taxpayer had with customers were in the nature of sales discounts. The stock warrants could be exercised only upon the purchase of certain amounts of computer equipment. The Court found the obvious future benefit to be incidental. It reasoned that the anticipated long-term benefits to the taxpayer were "softer" and "speculative" compared to the immediate benefit of anticipated sales.

PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998) seems especially problematic. The Tax Court decided that origination expenditures incurred in the creation of loans had created a separate and distinct asset (the loans) and therefore had to be capitalized. The appeals court, in reversing the Tax Court, thought the expenses incurred by the bank were quite routine (credit screening) and had not resulted in the creation of a separate and distinct asset at all. This shows that what we would think of as the easier test (separate and distinct asset as opposed to substantial future benefit) may not be that easy after all. These two courts were unable to agree on whether the loans constituted an asset. The Eighth Circuit in *Wells Fargo & Company and Subsidiaries v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *aff'g in part and rev'g in part Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999) echoed the Third Circuit's reasoning about expenses that were common and frequent. Since the taxpayer was paying the salaries anyway the future benefit was said to be only incidental. More specifically, the salaries were said to be only incidentally related to the future benefit.

(b)(5)(AWP), (b)(7)a, (b)(5)(AC)

[redacted]

SUMMARY AND CONCLUSION

(b)(5)(AC), (b)(7)a

[redacted]

(b)(5)(AC), (b)(7)a

[redacted]

(b)(5)(AC), (b)(7)a

[redacted]

(b)(5)(AC), (b)(7)a

[redacted]

(b)(5)(AC), (b)(7)a .

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

The taxpayer must also capitalize expenses attributable to contracts which it did not ultimately acquire (assuming the tests for capitalization are met), but may deduct those expenses as losses under I.R.C. § 165(a) in the year it ascertained it would not acquire those contracts. *Lychuk v. Commissioner*, 116 T.C. No. 27 (filed May 31, 2001), footnote 9; *Ellis Banking Corp. v. Commissioner*, 688 F.3d 1376, 1382 (11th Cir. 1982).

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